

APPENDIX

FOMC NOTES - PRF
December 17, 1996

Mr. Chairman:

Because of the number of topics I will be covering this morning, I have distributed an outline of my remarks attached to three pages of color charts and another document I will refer to at the end of my report. Thus, in brief: [read outline].

Turning to the first page of charts, you can see that from the Committee's last meeting until shortly after Thanksgiving, forward, short-term dollar interest rates remained quite steady. But from Tuesday, December 3rd, forward rates began to rise.

In contrast, in late November German forward rates came down as the possibility was raised that the next move in Bundesbank policy might be a further ease. On balance, most market participants expect neither an ease nor a tightening in German interest rates any time soon. But the stability of the rate outlook -- and the possibility of an ease -- is reflected in the compression of forward rates to a less than 10 basis point spread between the current three-month Euro-mark deposit rate and the "9 by 12" FRA (indicating three-month rates expected nine months forward).

Japanese forward rates are a bit lower than at the time of your last meeting, reflecting the slightly weaker-than-expected results of the Tankan survey. However, the more than forty basis point spread between the current three-month euro-yen deposit rate and the 9 by 12, reflects market participants' sense that the Bank of Japan would like to raise rates at some point in the new fiscal year which begins next April, IF the Japanese economy continues on its current course of recovery.

Looking back up the page at the U.S. forward rates, the compression which occurred in late November is perhaps as noteworthy as the upward movement which began in the first week of December. While during November the forward rate curve remained upward sloping, the narrow spreads between the current deposit rate and forward rates may have reflected some probability of an ease, or a squeezing of term and risk premia, or both.

Turning to the second page, it also appears that asset markets began to shift during the middle of the first week of December, two days before the Chairman's AEI speech.

As you can see in the first panel, the March CBOT futures contract on the long bond (expressed in price on the left-hand scale) peaked Tuesday, December 3rd and then began selling off that afternoon, continuing Wednesday and Thursday, December 4th and 5th, before the broader market reaction on Friday. In the cash market, the 10- and 30-year bonds also began backing up in yield on the 4th and 5th, while Canadian 10-year bonds backed up almost 50 basis points over these two days. Some, but not all, major equity markets also began losing ground early during this week, as shown in the second panel.

It is worth noting that, with the recent back-up in yields, U.S. long-term rates have just now returned to the levels around where they traded just after the Presidential election.

Looking back across the top panel, you can see that the March CBOT contract took a big jump up in price about a week before the election, on the release of the third-quarter Employment Cost Index. Both our bond market and global equity markets further rallied on election day and immediately thereafter. Thirty-year yields broke below 6.60 as a consequence of some very aggressive bidding in the 30-year auction on Thursday, November 7th. Subsequently, long bond yields traded in a new range, mostly in the 6.40s.

Speaking not as an economist (because I am not one), but merely as an observer of the animal spirits in the markets, it was this final leg of the rally, coming after the auction, that was never really vindicated by any further shift in the data. While the data releases in the past month have been mixed, they have really only confirmed the views which market participants quite aggressively bid into the market in late October and early November.

Whether it was a delayed case of indigestion from Thanksgiving, a premonition of the Chairman's AEI speech, or the greater proximity of year-end accounting deadlines serving to concentrate the mind, something changed by the middle of the first week of December and risk aversion and profit taking became the order of the day.

Despite the volatility in asset markets, as you can see on the 3rd page in the top and bottom panels, the dollar has traded in the upper reaches of its recent ranges, bumping up against it's highs of 1.56 against the mark and 115 against the yen.

Much of the impetus for these movements appears to have come from overseas and particularly from continental Europe, the relative weakness of which is not only reflected in dollar-mark, but also can be seen in the recent strength of the pound sterling

against the mark and the strength of the dollar against the Swiss franc, in the second and third panels.

The re-entry of the lira into the ERM weighed on the mark, as it was seen initially as increasing the probability of Italian participation in the first stage of EMU. Discussion of the possibility of a Bundesbank ease in policy also weighed on the mark.

A general sense of European weakness or perhaps European "limitations" -- and of an eagerness for a stronger dollar -- is now widely perceived by market participants, as evidenced during the period most strikingly in the posture of the Swiss National Bank and French politicians.

The Swiss franc has weakened through 1.30 against the dollar as the SNB has clearly articulated their recognition of the extreme weakness of the Swiss economy, their willingness to maintain low rates and risk some uptick in inflation, and their blunt statements that the Swiss franc has been overvalued.

The most aggressive oral intervention on the dollar's behalf has come out of Paris. In France the increasingly tangible consequences of EMU have inspired the political class to recognize the risks of beginning monetary union with "too strong" a euro against the dollar. Given the strictures on European fiscal policy, and the current historically low levels of official interest rates in Germany and France, a devaluation of the "core" currencies appears to be the only counter-cyclical policy tool available for further use. The recent oral intervention -- from French as well as German politicians -- is not so much seen as a direct cause of dollar strength but as a further admission of European macro-economic difficulties.

With all of this, many market participants have asked themselves -- yet again -- why isn't the dollar stronger? Our current account deficit and our recent trend of moderating growth and declining long-term rates provide the two most frequently cited, plausible answers. However, it is also worth noting how well the dollar has stood up in the last two weeks of significant declines in the asset markets -- events, which in recent memory, might well have pushed the dollar abruptly lower.

Turning to the Desk's domestic open market operations, we faced a number of discrete episodes of upward pressures in the funds market. In addition to the normal pattern of pressure resulting from auction settlement days, the month-end and social security payment days, there were a number of days of unexpected pressure when banks experienced wire transfer difficulties. This left the effective rates for the two completed maintenance periods a bit high, at 5.31 and 5.41 percent, while the current period's effective rate is now 5.27 percent.

While market participants had expected the Desk to conduct a coupon pass at the start of the month, I refrained from doing this principally because of my desire to avoid the risk of being in the position of needing to drain reserves through temporary operations in late January when we are forecast to be at new, low levels of operating balances.

Anticipating this period, I have been most comfortable planning to operate from the add-side because this is where both we and the market have the most experience. I would also like to avoid the risk of the potential misunderstandings which could result from the situation where we drain reserves in the morning but the funds rate spikes in the evening as the market comes to grips with the low operating balances. While our behavior might well be appropriate in terms of reserve management, it could subsequently appear as a cause of the late day rise in rates -- an awkwardness I would prefer to avoid.

Optimally, I would like to have been able to add around \$2 billion through coupon purchases this month and then return in January or February, when there is less uncertainty in our reserve forecasts, to purchase an additional \$3 or \$4 billion dollars of coupon securities. Had we done only one sector of the yield curve in December, and waited several weeks to come back and do the rest of the yield curve, the dealers would probably have complained even more loudly than they did and have erroneously inferred a change in the maturity structure of the SOMA portfolio.

When I announced the change in our approach to coupon passes over a year ago, I did inform the dealers that we might well conduct separate tranches not only on separate days but over the course of several weeks. As the rate of growth in reserve needs has moderated, this is precisely the flexibility that the Desk needs and which we intended to achieve with the change in approach. However, the idea that we might spread the purchases out of longer periods of time did not sink in with the dealers and I would not want to begin doing so without clearly explaining this to them.

The Committee has my memorandum describing the changes in the timing and announcement of the Desk's operations that I would like to implement. If there are no objections from the Committee on these two items, I would plan to announce them to the dealers at a meeting tomorrow afternoon. I thought I would also take that opportunity to discuss coupon passes. At the back of my distribution today is a copy of a draft handout I would propose to make available to the dealers and the press, which summarizes each of the three points I would plan to cover.

Mr. Chairman, we had no foreign exchange interventions during the period. We have completed the annual renewal of the System's reciprocal currency arrangements with all our central bank counterparts except the Bank of Italy, but we expect to complete this before the end of the year.

I will need the Committee's ratification of the Desk's domestic operations during the period.

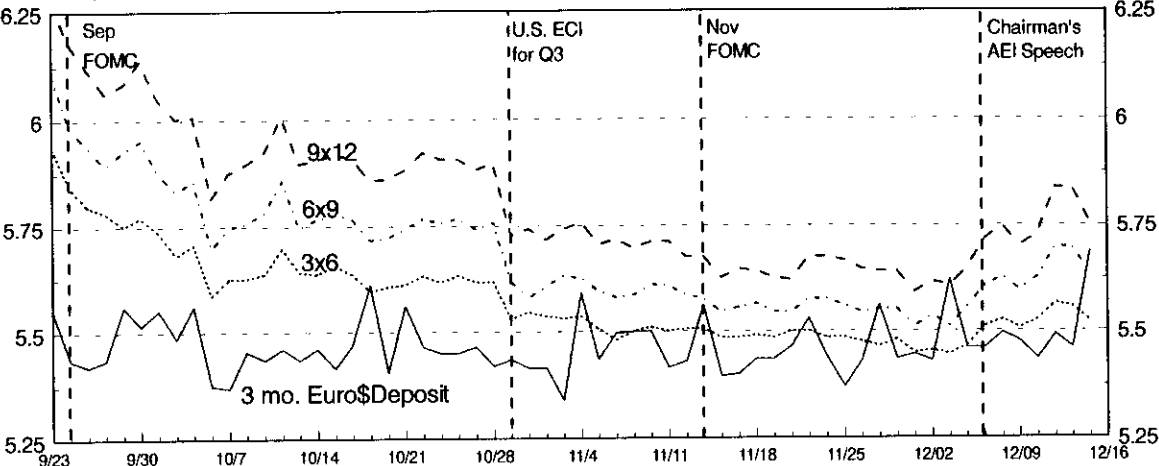
I would be happy to answer any questions on my report on market conditions, on the Desk's domestic operations, or on my memorandum and my proposed discussion with the dealers.

Outline of SOMA Manager's Notes

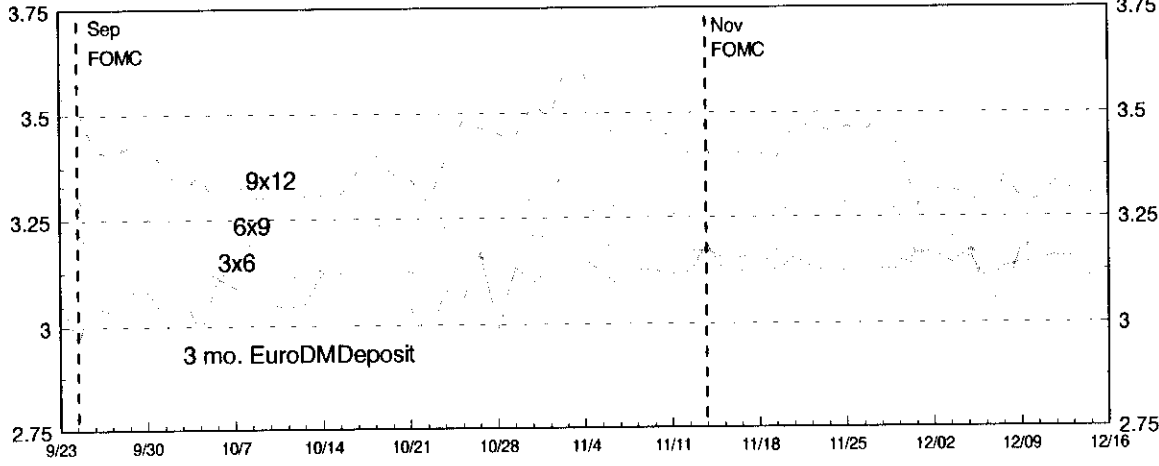
December 17, 1996

1. U.S. forward rates and U.S. long-term rates began backing up two days before the Chairman's AEI speech.
2. Recent shifts in German forward rates imply some probability of an ease by the Bundesbank; Japanese forward rates continue to suggest the possibility of a tightening by the Bank of Japan some time next year.
3. The dollar has seemed almost oblivious to the volatility in the asset markets, repeatedly pressing up against its recent highs against both the mark and the yen.
4. The fed funds rate has been a bit elevated, reflecting both normal, anticipated days of firm demand as well as some wire transfer problems.
5. The Desk did not to conduct a coupon pass, contrary to market expectations.
6. There were no foreign exchange intervention operations in the period.
7. The Desk has completed the annual renewal of the System's swap arrangements with all but one central bank.

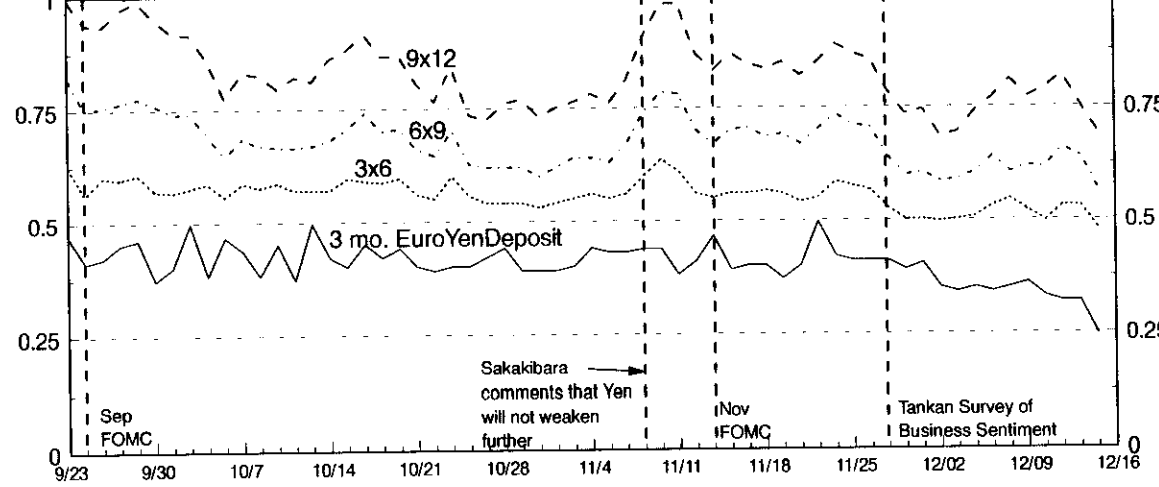
Percent **US Forward Rates**

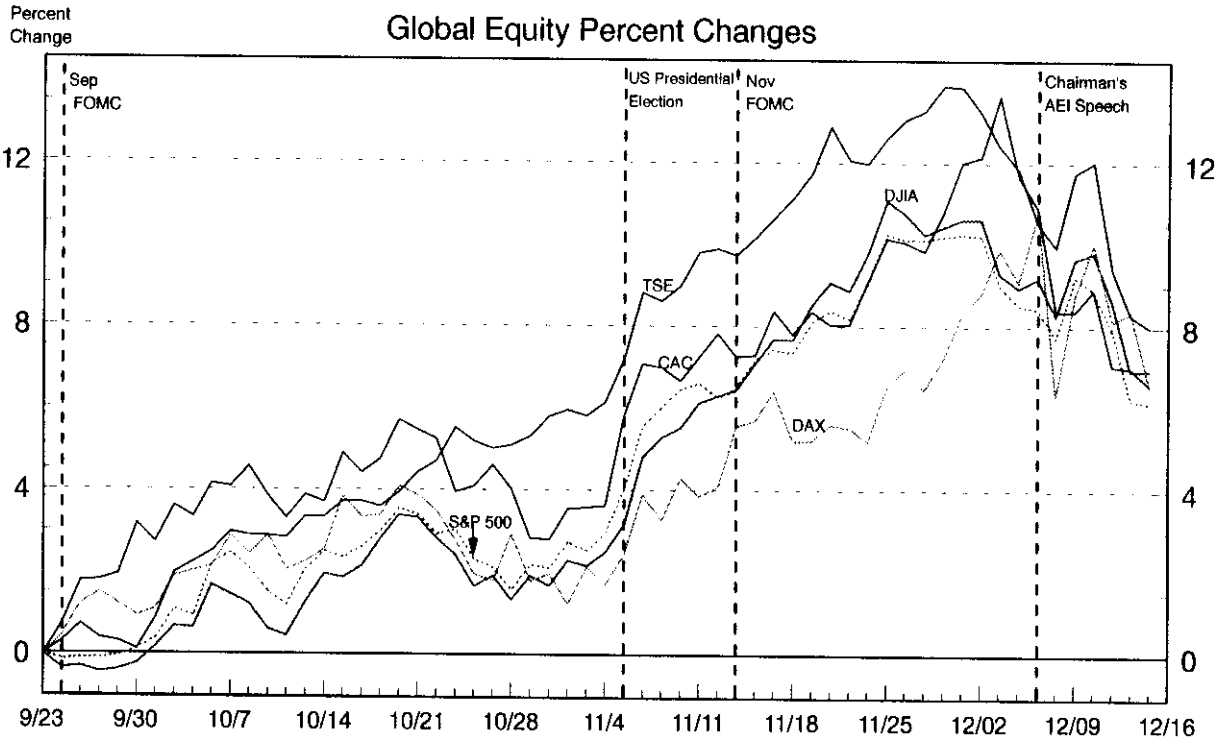
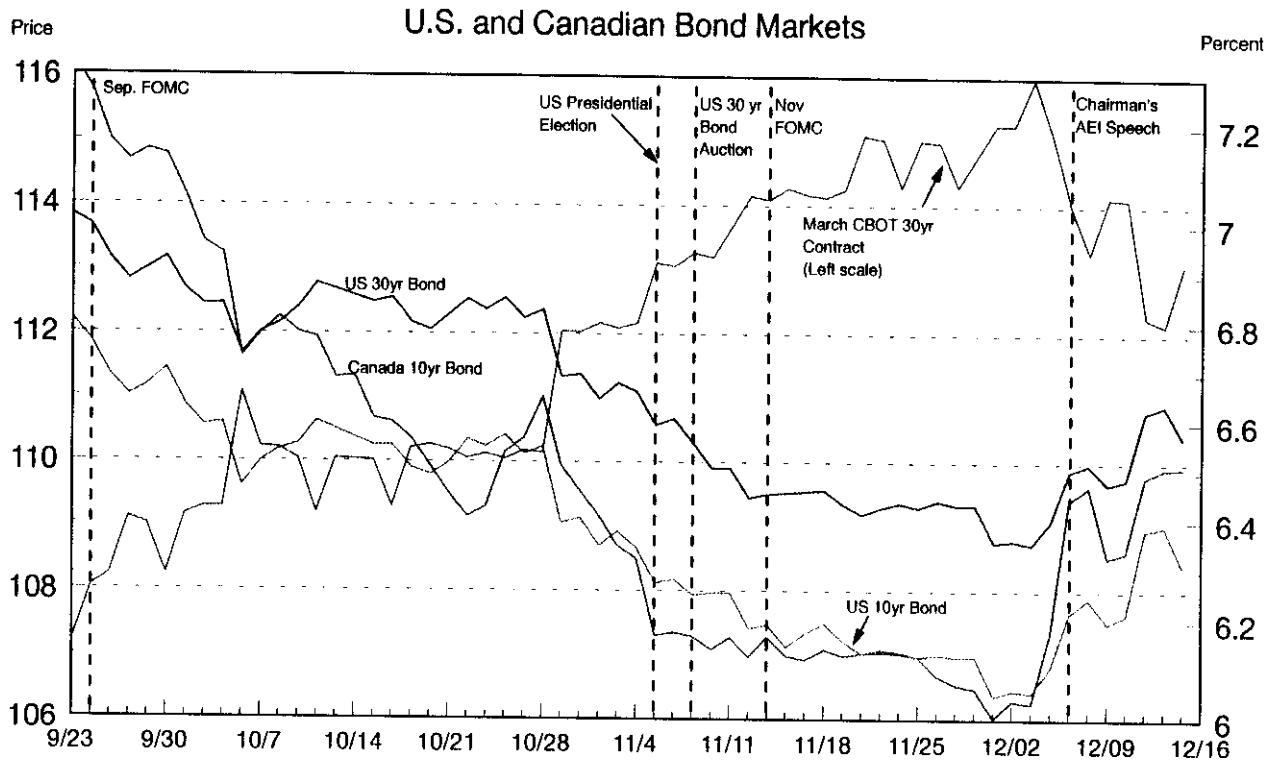


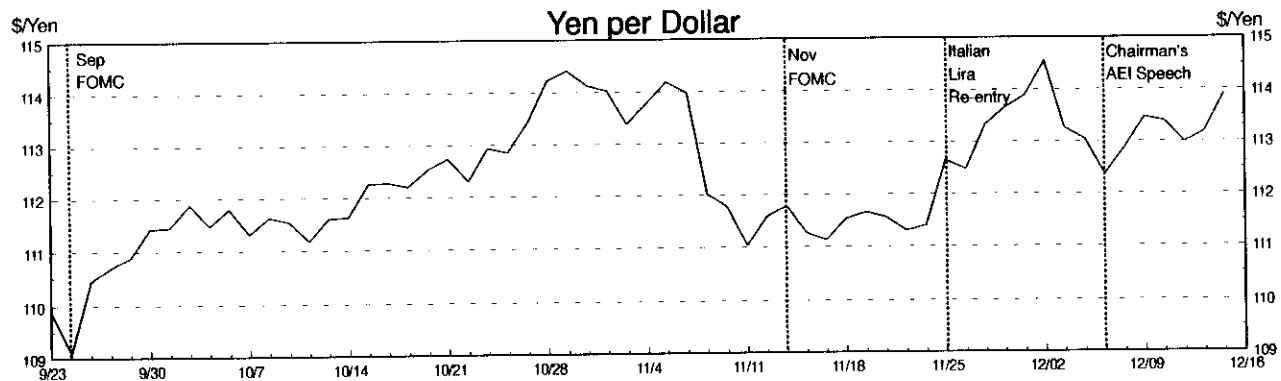
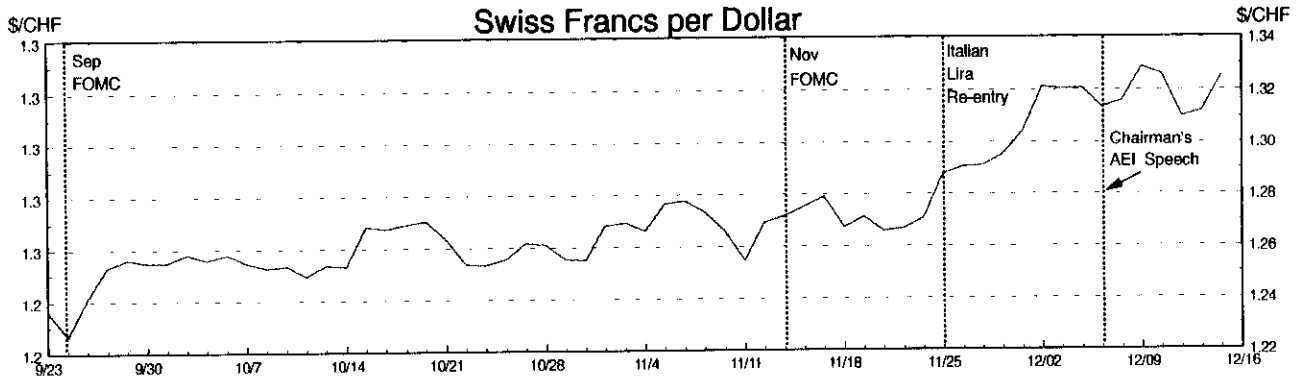
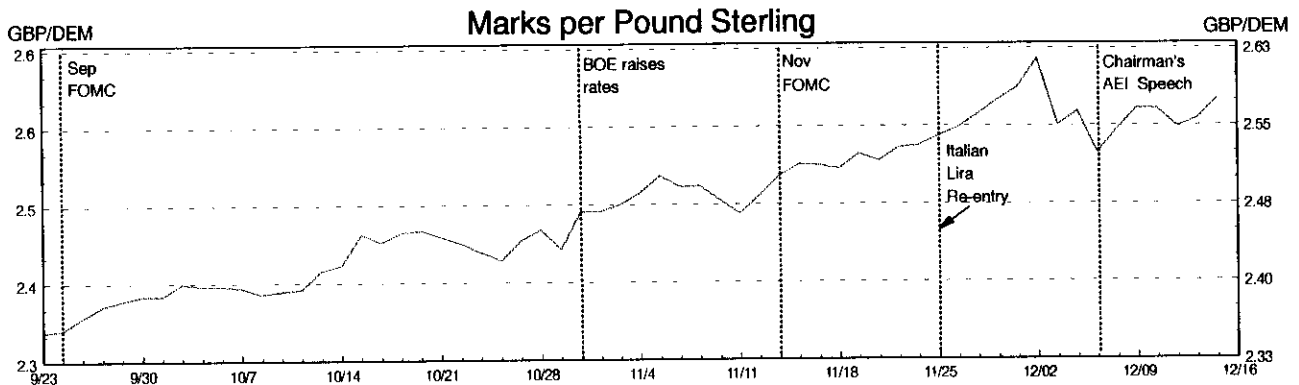
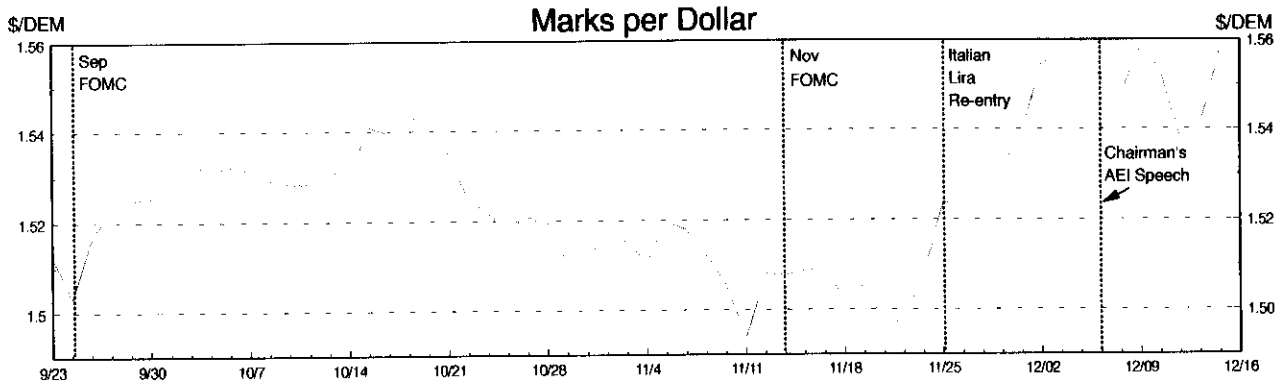
German Forward Rates



Japanese Forward Rates







-- D - R - A - F - T --
FEDERAL RESERVE BANK OF NEW YORK -- MARKETS GROUP

Changes in Domestic Open Market Operations
to be effective January 1997

1. The Desk's normal operating time will move one hour earlier.

- The normal time for the Desk to enter the market will move one hour earlier: from the current window between 11:30 and 11:45 a.m. to the window between 10:30 and 10:45 a.m.
- This is intended to move the timing of our routine operations closer to the hours when the financing market is most active. As a consequence, a higher total volume of propositions from the dealers is expected, giving the Desk somewhat greater flexibility in the size of operations.
- 10:30 to 10:45 a.m. will be the "presumed" time of the Desk's operations; however, because of market conditions or because of changes in our forecasts for reserve conditions, on occasion the Desk may operate earlier or later than this time. Situations may arise when the Desk would operate more than once a day.
- The cutoff time for informing the Desk of withdrawals from outstanding, withdrawable operations will move one-hour earlier from 11:00 a.m. to 10:00 a.m.

2. The par amount of System operations will be announced after their completion.

- Once a System operation is completed, whether temporary or outright, the Desk will inform all dealers via TRAPS of the par amount accepted. The Bank's Public Information office will make this information available at the same time.
- This will enable the Desk to communicate to the funding market the size of injections and drains of reserves; currently, the Desk only announces the size of intended "customer" operations.

3. Outright purchases of coupon securities may be spread over a number of days or weeks.

- A year ago, the Desk announced that coupon passes would be conducted in separate tranches for different sectors of the yield curve.

3. Outright purchases, continued

- Going forward, the Desk may purchase different tranches not only over the course of several days but also over the course of a number of weeks.
- This flexibility in timing will help the Desk inject reserves into the banking system as reserve needs arise without the need to wait for needs to accumulate to particularly high levels.
- The timing of passes for different sectors of the yield curve should not give rise to inferences about changes in the maturity structure of the System's portfolio. The Desk will simply be spreading out over a period of weeks the purchases it would have made over the course of a few days.
- The Desk may still conduct coupon passes over the course of just a few days but, in the future, will have the flexibility to spread these purchases out over longer periods when this fits better with the pattern of forecast reserve needs.

Michael J. Prell
December 17, 1996

FOMC BRIEFING

As you know, we delayed publication of the Greenbook by a day, to incorporate the November retail sales and CPI releases. But that didn't eliminate the risk that late breaking news could call into question at least our near-term forecast. Fortunately, there haven't been any major surprises.

On Friday, we received the October report on retail inventories. Combined with the figures on manufacturing and wholesale trade published earlier, they showed a rate of accumulation outside the motor vehicle sector well above the third-quarter pace. To hit our projection for the quarter, there would have to be a more moderate average increase in stocks in November and December. At this point, we're comfortable standing pat with the Greenbook prediction.

Not so in the case of industrial production. Total IP was up 0.9 percent in November, as we had anticipated, but we also learned that the October level was appreciably higher than initially estimated. It now looks like IP growth this quarter will be about a percentage point faster than the 2-1/4 percent annual rate in the Greenbook. Given the variability in the GDP-IP relation, this change doesn't compel an upward adjustment to our fourth-quarter GDP forecast; but it should reduce the chances of a shortfall.

One area of activity that exhibited notable weakness early this fall was homebuilding. However, this morning, we received the November report on construction. Multifamily starts and permits posted impressive gains. In the more important single-family sector, permits registered only a slight increase but starts jumped 7-1/2 percent--exceeding even the considerable rebound we had anticipated.

We'll split the difference between the two series and declare ourselves to have been basically on the right track in our thinking about the underlying direction of single-family building. I might note that yesterday we received word from the NAHB that builders responding to their December survey reported a marginal improvement in current sales and appreciably better sales expectations. All told, this market now seems to be on a pretty firm footing, given the current lower level of mortgage rates and elevated consumer confidence.

In sum, the news of the past few days has been consistent with our view that there are no serious impediments to a continuation of moderate economic growth. Indeed, we still believe the greater risk might be that aggregate demand will be stronger than we have forecast, leading to a more pronounced upswing in inflation.

The behavior of the stock market is a major factor in that concern. There are several aspects to this story. One is that the surprisingly high level of the market may be signalling that monetary policy is more expansionary than we thought. The long-running rally has often been characterized by market sages as "liquidity driven." What that means isn't always entirely clear, but it usually means simply that short-term interest rates are low relative to the expected returns on stock market investments. The question is whether this liquidity is so great that it drives the prices of shares--and perhaps other assets--to levels that stimulate excessive demand for goods and services.

This brings me to the core of the quandary we faced in our projection--the seeming disconnect recently between the stock market and the real economy, especially consumer demand. Taking the reported rise in the personal saving rate since 1994 at face value--or even

discounting it somewhat--we haven't seen the response we would normally expect of consumer spending to what has been an enormous increase in household wealth. I won't reiterate all the conjectures we've offered about possible explanations of this shortfall. The key point with respect to the forecast is that we have not allowed for any meaningful catch-up of spending with the capital gains that people have experienced.

Moreover, further capping the prospective strength of demand, we have forecast a stock market decline that carries share prices in 1997 about 7 percent below their recent peak; prices then recover, but do not reach their prior highs in 1998. This implies an appreciable decline in the ratio of household wealth to income. The weakening of the market in recent days may be a sign that we're going to be right this time. But history doesn't provide much assurance on that score; although we expect that profits will be somewhat disappointing to market analysts, it might well take a significant Fed tightening move or some important external shock to really stall this bull market.

In fact, one of the elements of our forecast that we see as a damping influence on demand could help bolster the stock market. I refer to our assumption that there will be agreement on a budget balancing plan. Although we have projected some easing of bond yields from current levels, it's quite conceivable that agreement on a fully credible fiscal plan would lead, at least for a time, to a more substantial decline in real rates than we have anticipated--with favorable effects on equity values. And, of course, an associated risk would be that such a decline in real rates could result in a weakening of the dollar on exchange markets.

In short, while it seems most probable that financial market conditions will prove consistent with only moderate growth in demand,

it's not difficult to envision scenarios in which they foster a more robust expansion. And, to repeat, we don't think the economy can absorb this without inflation picking up appreciably. The recent reports from the labor market have reinforced our view that well-qualified workers are in short supply and that wages are responding. Though prices outside the food and energy sectors still have not evidenced a corresponding acceleration, we think higher labor costs will eventually be passed through to some degree.

This is not to say that the risks surrounding our forecast are one-sided: One might argue that the stock market will fall sharply of its own weight, or that household debt loads or tighter lending will weigh more heavily on consumer spending, or that capital spending will falter after a hefty run-up. And, one might find in the favorable trend of the core CPI and some other price indexes greater grounds for optimism about inflation prospects at recent--or even higher--rates of resource utilization.

Thus, there clearly is still room for considerable differences of opinion on the economic outlook and the associated policy implications. But, perhaps like some of you, we'd be more confident about the prospects for a reasonably stable economy if the stock market were to back off somewhat further in the coming months.

Ted will now offer some remarks on the outlook for the external sector.

E.M.Truman
December 17, 1996

FOMC Presentation -- International Developments

I have not made a presentation at the last several Committee meetings in large part because I felt that there was not much new to say about the external sector of the economy. As Mike has noted recently with respect to the economy as a whole, our basic forecast has not changed dramatically for some time. We expect U.S. external deficits to continue to widen. This forecast is based on our projection that growth abroad will be insufficient to outweigh (1) the influence of U.S. growth, (2) the fact that our income elasticity of demand for imports continues to exceed that for our exports, and (3) the fact that these forces operate from the starting point of an initial imbalance. The recent strengthening of the dollar contributes further to the trend of moderate deterioration. Consequently, in the December Greenbook, we projected that the external sector will make a net negative contribution to growth of U.S. real GDP over the four quarters of this year of about 3/4 of a percentage point, 1/2 a percentage point next year, and a bit less in 1998. To provide some perspective, our forecast at the beginning of the year was that net exports of goods and services would be a slightly negative factor in the outlook over 1996 and 1997.

Our forecast for this year incorporates a net positive contribution to GDP growth from net exports of goods and services in the fourth quarter. We have only fragmentary data for the quarter as yet, but we are anticipating a small, temporary boost from the effects of the GM strike and from the influence of the residual seasonality in the data. We are forecasting that the October data that will be released on Thursday will show a drop in the monthly deficit on goods and services, partly due to a recovery in shipments of large jet aircraft. Such special factors, including, importantly, fluctuations in supply and demand for semiconductors and computers (which on balance have been a net plus in our external accounts so far this year) and trends in net service receipts (which have been weaker than expected of late), always influence our near-term forecasts.

We have been somewhat disturbed by the progressive weakening over the course of this year in the external sector in both the published data and our forecasts. We consequently have taken a look at whether there has been a fundamental shift that we have been missing. The answer, as best we can tell at this point, is negative. Based on historical relationships, our models explain about 85 percent of the net change since January in the contribution of the external sector to GDP growth in 1996 and a bit more than half of the change in our projection for 1997. (Much of the remainder of the change in our forecast for next year can be traced to a shift in trade in computers and semiconductors from an unusual surplus this year back into deficit next year as conditions in that area return to a more normal pattern.) The errors in our equations for imports excluding oil, computers and semiconductors have been in the direction of underpredicting imports; at the same time, our equations for exports excluding agricultural products, computers and semiconductors have tended to underpredict as well. These equation errors to date have tended to be offsetting. These relationships are driven by three fundamental factors -- foreign growth, U.S. growth, and the foreign exchange value of the dollar as a proxy for price competitiveness. I thought it might be useful to illustrate how changes in these factors have affected our outlook since the beginning of the year; in the process you can evaluate the risks in our forecast.

Turning first to foreign growth, compared with where we were in January, our overall outlook for foreign growth is unchanged for this year, and slightly stronger for next year. This overall neutral-to-positive factor, of course, masks changes in trends in various parts of the world.

Earlier this year, we marked down our forecast for European growth, but since then we have strengthened it slightly for this year and a bit more for next year as the effects of unanticipated declines in interest rates and weaker currencies in core European countries have outweighed those of continued fiscal restraint.

For Japan, we have lowered our forecast of GDP growth for this year by a bit, but most of

the adjustment came since the November Greenbook in response to revised Japanese data. We are projecting somewhat slower growth for next year, as the influence of the weaker yen does not quite offset a substantial shift toward fiscal restraint.

For North America, we have tended to strengthen our forecast for Mexican growth going into 1997 as that economy has picked up somewhat more strongly than we had anticipated, which has more than offset greater-than-expected weakness in Canada this year. We have moved some of the Canadian growth that we expected this year into 1997.

We have been pleasantly surprised with growth in South America this year and have carried some of that surprise through to higher growth next year.

For Asia other than Japan, growth has been weaker than expected; the weakness of the yen, the collapse earlier in the year of the semiconductor market, and some degree of policy restraint have combined to slow growth in this region. We are expecting some pickup next year, but I believe that this is an area of some downside risk to our forecast.

Our outlook for foreign growth going forward is for moderately faster growth than we now are forecasting for 1996 -- an increase of about 1/2 a percentage point to close to 4 percent growth over the next two years. We think that the risks are fairly balanced overall.

The second fundamental factor affecting our outlook for the external sector, U.S. growth, has been a major source of surprise this year. We have moved up our forecast for growth this year by a full percentage point since January; most of the adjustment occurred early in the year. We have also edged up our forecast for 1997. Thus, the level of economic activity is considerably higher next year. This factor explains most of the adjustment since early in the year in our outlook for the external sector for 1996, but plays a relatively smaller role in the change for 1997.

Third, turning to the dollar, against the currencies of our major trading partners -- G-10 as well as non-G-10 -- the dollar has strengthened in real terms about 4-1/2 percent this year, and we

project that it will strengthen a further percentage point next year, about twice the overall amount of appreciation we anticipated early in the year. In terms of the G-10 currencies, the dollar moved up strongly during the first half of the year, fell back during the summer, and has reached new highs in recent weeks. In real terms, the dollar has returned to roughly its average level over the past ten years, a point that it last reached (on the way down) in early 1994. This unexpected appreciation, of course, has contributed, but not in a dramatic way, to the weaker performance of net exports this year, and it is projected to make a relatively larger contribution next year.

In considering the risks associated with the dollar, it is useful to try to reach a judgment about why the dollar has appreciated this year. In my view there are two factors: First is the relative strength of the U.S. economy; this was reflected in an absolute and relative rise in U.S. real long-term interest rates that mostly occurred in the first half of the year. Based on statistical relationships, the net change in the differential in real long-term interest rates of about 120 basis points (about equally divided between an increase in U.S. rates and decline in rates on average in other G-10 countries) might be expected to have been associated with more than the roughly 6 percent real appreciation of the dollar over the past 12 months. Second, the evidence over the past several months points on balance to the conclusion that the dollar has been boosted by the prospect that the third stage of EMU will commence on January 1, 1999, and that it will be less than an overnight success. I am disinclined to attribute much direct influence to the recent oral intervention coming from Europe and directed at boosting the dollar, as a substitute for lowering interest rates.

A potential negative factor for the dollar that has emerged over the past year has been the fact that the U.S. external deficit has widened not only relative to our projection but even more so relative to the consensus among private forecasters. Based on our forecast and an assumption that private forecasts actually influence the market's behavior, the market will continue to be disappointed next year. In our own projection process, we may have allowed ourselves to be misled a bit by the

dramatic improvement in our net exports in the second half of last year. We hope that we have now overcome that tendency, but private forecasters appear still to be lagging behind. In this context, one interpretation of the flurry in financial markets last week associated initially with the comments of Bob Hormats is that markets were reacting not to the silly notion that the Japanese were going to decide suddenly to bring down the U.S. bond market, but to a more rational question of how easy it will be for us to continue to attract the net capital inflows to match our growing current account deficit without exerting serious upward pressures on dollar interest rates and downward pressures on dollar exchange rates.

These specific influences on the outlook for the dollar may be less important for the behavior of financial markets generally than are the more general euphoric conditions in global financial markets -- stock markets in many countries, bond markets in many countries, as well as investments in emerging market economies. This euphoria appears to be based to a large degree on extrapolative expectations: short-term interest rates in Japan, Switzerland, and a number of other countries to a lesser degree will remain low indefinitely, stock markets will continue to rise, exchange rates will continue to be relatively stable, and EMU will progress without serious hitches. I am sure you could each add more elements to this list. Moreover, it is not clear that disappointed expectations will, on balance, adversely affect the dollar. Conflicting expectations are what makes markets and keeps life interesting -- sometimes to excess.

That completes our presentation.

December 17, 1996

FOMC Briefing
Donald L. Kohn

Once again data becoming available since the last Committee meeting have suggested moderate growth and damped core inflation. This information, along with continuing uncertainty about the relationship of economic activity to inflation, would seem to provide the Committee ample reason for leaving the stance of policy unchanged at this meeting. In these circumstances, I thought I would confine my remarks to two collateral issues--one specific, the asymmetry in the directive, and one general, asset prices and monetary policy.

Turning first to asymmetry, views outside this institution on the balance of risks and likely direction of the next policy move show an interesting dichotomy. Markets are no longer pricing in tightening; expectations that policy will remain unchanged are evident not only in quotes on federal funds and Eurodollar futures contracts for the next few months and quarters, but also over a longer horizon, at least judging by the yield curve, where the spread between rates on 10-year notes and federal funds is now about at its long-term average. Nonetheless, an overwhelming majority of economists working for the primary dealers see a firming of policy sometime next spring.

This latter judgment--or at least the view that your next move is more likely to be a firming than an easing--probably stems from an outlook similar to the staff forecast, and an assumption that you would not be satisfied with the upcreep in underlying inflation it implies. Projected inflation pressures come, of course, from an expectation that the economy will continue to operate a bit beyond its

potential--at least as gauged from the labor markets--and are supported by the upturn that already seems evident in many measures of wages and labor costs.

Moreover, financial conditions have eased in some key respects over the last several months, possibly buoying aggregate demand. Specifically, intermediate- and long-term rates are about a half point lower than they were last summer--most likely in real as well as nominal terms--and equity prices have risen further on net. Growth in broad money and bank credit has picked up in recent months and risk premiums remain quite narrow in securities markets, suggesting ample liquidity and readily available credit overall, despite some pulling back in the supply of consumer credit.

If, in light of these considerations, the Committee wants to signal that its major concern still lies on the side of rising inflation, and that it would react promptly to counter any such tendency that might emerge, it might want to retain the current bias in the directive.

However, the Committee may see the odds on the direction of the next policy action as more evenly balanced. A number of you remarked at the last meeting that you felt "less asymmetrical". Since then, core inflation has remained quite favorable and the unemployment rate has inched up. Moreover, the possibility of further fiscal consolidation and the continued sluggishness in consumer credit may suggest the existence of some constraints on aggregate demand.

A symmetrical directive might be justified even if the Committee still thought the odds were tilted toward a need to tighten at some point, but considered the threat of higher inflation greatly reduced. In part, this decision should be based on what the Committee wishes asymmetry to convey about its intentions and assessments. Is

it an indication of the balance of risks, or should it retain something of the more operational cast it once had? If the latter, it could be reserved for situations in which the Committee feels that the risks are sufficiently lopsided to call for a relatively quick and strong policy response to evidence suggesting adverse outcomes were in train. Judging from the flat structure of interest rates, the markets probably would not be greatly surprised by a shift to a symmetrical directive, or by the retention of asymmetry, and the rationale for either decision would be explained in the minutes, which are released simultaneously with the directive.

A notable aspect of the intermeeting period has been a pickup in financial market volatility, albeit from a very low level. The efforts of market participants to discern the role of asset market prices in monetary policy seem to have been among the many contributing factors. I have a few tentative thoughts on this subject.

Clearly, the prices of financial and other assets generally are not themselves objectives of monetary policy--except perhaps for the exchange rate in a fixed-rate regime. For the most part, they are relative prices, reflecting, in the broadest financial markets, the productivity of capital and the value placed on consuming now rather than later. These prices presumably would affect your monetary policy decisions only as they told you something about the prospects for achieving your legislated objectives of maximum employment and stable prices over the long run.

Moreover, the prices of bonds, equity, real estate and other long-lived assets are inherently volatile. They embody the discounted present value of an expected flow of returns. Relatively small changes in expected returns or in discount factors can cause large changes in asset values without being associated with underlying

instability in the economy or changes in the inflation outlook. Indeed, movements in bond, stock, and foreign exchange rates can, in effect, absorb economic shocks and help the monetary authority accomplish its stabilization objectives. The so-called bond market vigilantes are a good example of this phenomenon, when they get it right. In the face of economic shocks, stabilizing asset prices would render this mechanism inoperative, making economic activity and inflation more volatile.

Monetary authorities might be concerned about asset prices when they judged that they were inconsistent with a path for the economy and prices that would achieve macroeconomic objectives. One source of such an inconsistency might be the market's failure to understand the central bank's goals or believe that they will be accomplished. Assuming policy was correctly aligned, taking account of the asset prices, the best response to this sort of market error would seem to be clearer explanations of policy objectives and patience while the market learned about the central bank's intentions. Alternatively, markets may understand and believe the central bank's objectives, but have a different view of the underlying forces in the economy. If, after consideration, the central bank still held to its assessment, a similar prescription would seem to be called for: that is, no change in policy and allow markets to adapt. In both these cases, policy might need to be recalibrated as market prices adjusted to realities.

But there may be a message in asset market prices as well. Markets that appeared misaligned could be accurately indicating that the stance of policy really wasn't appropriate--that, for example, high stock prices meant that real interest rates were too low to contain inflation. In such circumstances, one might expect to see

fairly broad-based signals from a variety of asset markets, at least for major policy errors, as we observed in the late 1970s. Currently, however, equity markets stand out. Only a few other markets, such as residential real estate, have experienced appreciable increases in prices. Notably, commodity prices have been flat and the dollar firm.

Nonetheless, to some extent, the elevated stock market may be signalling that policy is a little too accommodative to cap inflation--as it is in staff forecast. In that case, raising rates at some point would be an appropriate response to overly high stock prices, and the subsequent leveling off or decline in prices would be an important part of the mechanism through which monetary policy trimmed aggregate demand.

The more difficult situation--and the one inherent in a number of readings of the stock market--would arise if the central bank saw its policy stance as about right, but also judged that prices in an important asset market were way out of line, resulting not from temporarily skewed expectations about policy or the macro economy, but from markets fundamentally misreading the forces affecting them or from a speculative price bubble. The central bank could anticipate that the market would correct itself at some point, perhaps by a considerable amount, but the timing of the correction and the consequences of the adjustment process itself might be highly uncertain.

Such a situation could complicate the conduct of policy to a degree. For one thing, policy would need to take account of the effects on aggregate demand of the rise and expected fall in asset prices--a problematic task when the amount and timing of the asset price cycle is difficult to predict. For another, the response of

asset markets to policy actions might be hard to anticipate, especially if the markets thought the monetary authorities were paying them close attention.

The United States faced such a problem in the mid-1980s with respect to the foreign exchange value of the dollar. In the first half of 1980s, the dollar was rising rapidly to what seemed like unsustainable levels, but how high it might go and when it might fall were difficult to predict. At that time, the government eventually used public statements and intervention, their economic equivalent, to foster needed adjustment. And, once adjustment was underway, policy needed to take account of the effects on demand and prices of the falling dollar and to be sensitive to the interactions of policy actions with unsettled market expectations. It is difficult to read the motivations of policymakers in the past. But the policy decisions of that era seem, in retrospect, fully justified by the developing macroeconomic situation, without reference to the value of the dollar, except through its direct economic effects. And these decisions promoted an 8-year economic expansion.

Indeed, adjusting policy specifically to affect the level of the stock market or another asset market, beyond that called for by the macroeconomic situation, would seem to imply the Committee held firm views that the market was misaligned, that without a tightening the market might become more misaligned, and that the length of time the misalignment persisted or the size of the eventual market correction, by itself, could have important implications for the economy. Such implications might arise if larger or more delayed corrections heightened the chance of price overshooting on the down side owing to market dynamics, or increased the incidence of failures among market

intermediaries, adversely affecting confidence and perhaps the payments system. However, evidence of systematic or predictable price overshooting is scarce, as are incidents of systemic effects from intermediary failure when monetary policy has been sensible.

Moreover, there are alternatives to tightening monetary policy to address such concerns. If the Committee were convinced that the market was over-priced and wanted to correct that condition, it might consider continuing to foster public discussion to encourage market participants to examine the premises behind the level of stock prices and the risks of a major market decline. In addition, working with the SEC and other supervisors, it might attempt to gain better assurance that intermediaries and market mechanisms are strong enough to withstand sizable price fluctuations. And finally, the FOMC could be prepared to react flexibly to a major break in asset prices, should that occur.

In sum, Mr. Chairman, as you remarked in your speech, consideration of asset prices is a necessary, but complex, element in monetary policymaking. Obviously, the effects of asset prices on spending and inflation play directly into your decisions, and such prices can be helpful indicators of the stance of policy. Moreover, badly misaligned asset prices can complicate the conduct of policy. But aiming to stabilize such prices may well be counterproductive, and adjusting policy to, for example, prick a presumed asset bubble when that adjustment is not called for by the macroeconomic situation--or foregoing a needed policy adjustment out of concern about its effects on asset prices--would seem to require strong convictions that the level of asset prices was indeed inappropriate and could become more so, considerable concern about the effects of the duration of the

bubble or size of the eventual collapse, and little confidence in alternative means of dealing with the situation.